Comments on the Kentucky Pension Task Force Recommendations

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The Pew Center on the States and the Laura and John Arnold Foundation presented testimony to the Kentucky Pension Task Force last Fall on how to reform the public employee retirement system for Kentucky state and county employees. They set three goals for state policy makers and gave recommendations on how to achieve them. The three goals were:

1. Create a credible plan to reduce the funding gap
2. Make sure the plan is sustainable and doesn't put taxpayers at risk of future funding challenges
3. Ensure that the compensation offered helps recruit and retain talented public sector workers

Unfortunately, although Pew and Arnold took a swing at all three goals, they missed them all. Let's look at each one.

Reduce the Funding Gap

The foundations miss the first goal completely. Kentucky's enormous pension funding gap is not the result of overly generous benefits (pension benefits are about average for public employees nationally and when combined with low salaries leave Kentucky's public servants undercompensated by nine percent compared to the private sector), or even because of poor investment performance. Rather, it is the result of the state's repeated failure to meet its obligation to pay each year's actuarially required contribution (ARC). If the state's actuary tells the legislature it needs to contribute hundreds of millions of dollars to the pension plans and the legislature responds by contributing significantly less, that failure creates a funding gap. When the state does as Kentucky did and fails to make the ARC in 14 years out of the last 21, the result is a large unfunded liability -- $12 billion in Kentucky's case, as determined by Pew.

What have Pew and Arnold recommended to prevent this from happening again? Nothing. Merely suggesting an acceleration of payments to make up the years of lost revenue is meaningless. The same government that took the easy way in the past, failing to make the ARC two years out of every three, can be expected to do so again in the future if nothing changes to compel different behavior. This is especially true because the amounts required to meet the ARC and make up for past omissions will be even greater than the contributions that were skipped in the past.

Other states have removed any discretion with respect to the ARC, either through state constitutional amendment or statutory proscription. It is a shame that Pew and Arnold make no recommendation and leave the problem entirely unaddressed. Strike one!

Create a Sustainable Plan

They miss on sustainability, too. According to an actuarial analysis by the Chief Actuary of Bolton Partners, the cash balance plan the Foundations propose will cost substantially *more* than the current system. This could be a good result if appropriate revenues were identified to pay for the additional benefits, but it appears that Pew has simply underestimated the cost. The Bolton analysis finds that the cash balance plan's benefit is equivalent to an interest credit of 9%, not 8% as Pew has calculated it.

It will take further review to determine whether Bolton Partners or the two foundations are right, but Bolton points to the case of Downes v. Wisconsin Energy Corporation, litigation which settled in 2012 involving a plan design with the same interest crediting formula, where the plan incorrectly determined the cost of the cast balance plan the employer wound up paying $45 million in damages.

In any event, and regardless of which actuarial analysis is correct, Pew admits that its proposed plan is no less costly than the current system, undermining the claim that the new plan is more sustainable. Another swing and a miss: strike two.

Recruitment and Retention

The third goal is to help recruit and retain a talented public sector workforce, but because the proposed cash balance plan is designed to shift risk from the employer to employees, it will make public service less attractive and recruitment more difficult. Moreover, it is actually designed and intended to *reduce* retention.

Even though it will cost more, the foundations' proposed plan will *increase* retirement insecurity. Though benefits on average may be more generous because of Pew's miscalculation, they will be tied to market returns as opposed to age and years of service, so for any individual the returns will be less certain and could be substantially less than under the current system.

Public sector workers in particular value secure pensions. If Kentucky's government employers want to recruit employees of the same quality, they will need to increase pay to offset the loss of a secure benefit.

Retention will be an even bigger problem. The cash balance will increase employee turner because it is designed to diminish the reward for long service, to eliminate the "backloading" of benefits in a traditional defined benefit plan like the current system.

As turnover increases, recruitment and training costs will increase, and they are substantial.

- The Society for Human Resource Management estimates that it costs $3,500 to replace one $8.00 per hour employee when all costs – recruiting, interviewing, hiring, training, and reduced productivity are considered. SHRM's estimate was the lowest in a survey of 17 nationally respected companies and organizations. The cost would be much higher for a professional employee.

- Other estimates range far higher: 30-50% of the annual salary of entry-level positions and more than 100% of annual salary for middle and high level employees.

Once the incentive to remain in the system and gain the increasing benefits of long service are lost, employee decisions to leave will be more likely to be based on short-term financial considerations, including the investment returns to the cash balance plan. Since bear markets tend to coincide with economic downturns, Kentucky's government employers will retain employees when labor markets are slack and replacements would be relatively easy to hire, but need to hire more workers when the job market is tight. This will not only make hiring more challenging, but will also exacerbate cyclical fluctuations in Kentucky's unemployment rate.

So a third swing and miss on retention and recruitment. In terms of the goals Pew and Arnold set out for themselves, the two foundations struck out.

Ross Eisenbrey, Vice President of the Economic Policy Institute, a non-profit, non-partisan think tank created in 1986 to broaden discussions about economic policy to include the needs of low- and middle-income workers.

The Kentucky Public Pension Coalition hosted a panel of experts on January 30, 2013 to discuss Pew's dangerous pension proposals, the role that public pensions play in the local economy, and the state of retirement security. The panel intended to educate legislators on the truth about Kentucky's public pension system, and counter many of the myths and inaccuracies that exist about public pensions.

Panelists included: Jason Bailey, Director of the Kentucky Center of Economic Policy and Diane Oakley, Executive Director of the National Institute on Retirement Security. Their presentations can be seen at: http://www.publicpensioncoalitionky.org/panel-of-experts/